DEPARTMENT OF STATE REVENUE

02-20090706.LOF

Letter of Findings: 02-20090706
Corporate Income Tax
For Years 2002, 2003, and 2004

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Corporate Income Tax – Imposition.

Authority: IC § 6-3-2-2; 45 IAC 3.1-1-62; IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dept of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983); Butler Bros. v. McColgan, 111 P.2d 334 (CA.1941), aff'd, 315 U.S. 501 (1942); Barclays Bank PLC v. Franchise Tax Bd. of California, 512 U.S. 298 (1994); I.R.C. § 831; Treas. Reg. § 1.801-1; Letter of Findings 02-20090918 (March 12, 2010).

Taxpayers protest the Department's proposed assessments based on combined returns.

II. Corporate Income Tax– Net Operating Losses ("NOLs").

Authority: IC § 6-3-2-2.6; Phoenix Coal Co. v. C.I.R., 231 F.2d 420 (C.A.2 1956).

Taxpayers protest the Department's disallowance of the NOLs.

III. Tax Administration – Underpayment Penalty and Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2; IC § 6-3-4-4.1.

Taxpayers protest the imposition of the underpayment penalty and the negligence penalty.

STATEMENT OF FACTS

Taxpayer ("Parent") is a multinational company that manufactures and sells consumer goods. Through its multi-tier corporate structure, Taxpayer wholly or partially owns, as well as directly or indirectly controls, its multi-tier subsidiaries. Taxpayer and some of its subsidiaries/affiliates (collectively, "Taxpayers") either file separate or consolidated Indiana corporate income tax returns based on their Indiana activities.

The Indiana Department of Revenue ("Department") performed an income tax audit of tax years 2002, 2003, and 2004. Pursuant to the audit, the Department proposed that Taxpayers file combined adjusted gross income tax returns for those years to fairly reflect their income derived from sources within Indiana. Specifically, the Department's audit found that Taxpayers maintained a unitary relationship in which Taxpayers, through corporate restructuring arrangements, facilitated certain intercompany transactions, such as loans and interest payments, intellectual property licensing and royalty payments, management administrative services and fees, and three-party business operations and mark-ups. The Department concluded that those intercompany activities created multiple business expenses and corroborating deductions which resulted in understatements of the deemed Indiana income. To fairly reflect what would be Taxpayers' Indiana taxable income, the Department's audit, thus, proposed combination of Taxpayers' filings, which eliminated Taxpayers' intercompany transactions primarily among and within several groups, which are designated as Group A, O, and B, as follows:

Group A: Primarily there are five (5) subsidiaries/affiliates, designated as: (1) Manufacturing Company A1, (2) Intangible Property Company A2, (3) Sales and Distribution Company A3–a limited partnership, (4) Holding Company A4, and (5) Partnership A5, which provides management administrative services to A1 and A4. According to Taxpayers' documentation, A1 is a wholly-owned subsidiary of A2. A1, however, also owns twenty-one percent of A2, and Parent has the remaining seventy-nine percent of ownership. Additionally, A3 has two partners: Parent and A1. Parent owns the majority of A3 while A1 owns a minority share (1 percent in 2002 and 2003, 11.9 percent in 2004) of A3. A1 also wholly owns A4. Parent and its wholly-owned holding company O1, a Delaware corporation, are the only two partners of A5.

Group O: Primarily there are five (5) affiliates/subsidiaries, designated as: (1) Holding Company O1, (2) Partnership O2, (3) a claimed foreign operating company O3 and (4) Insurance Company O4. According to Taxpayers' documentation, Parent wholly owns O1 which, in turn, maintains ninety-nine percent ownership of O2. Parent has the remaining one percent ownership of O2. Parent through its wholly-owned multi-tier subsidiaries owns one-hundred percent of O3 and O4. O3 and O4 then share the co-ownership of a limited partnership O5, in which O4 has ninety-nine percent ownership and O3 has the remaining one percent ownership.

Group B: Primarily there are five (5) subsidiaries/affiliates, designated as: (1) Group-Parent/Intangible Property Company B1, (2) Manufacturing Company B2, (3) Manufacturing Company B3, (4) Intangible Property Company B4, and (5) Sales and Distribution Company B5. According to Taxpayers' documentation, Parent wholly owns B1 through one of its first-tier subsidiary, a Capital Corporation. B1 wholly owns B2 and B5. B1 also has ninety-nine percent ownership of B4. Additionally, B4 wholly owns B3.

The Department's audit also disallowed some of the NOLs incurred by Taxpayers and which Taxpayers carried forward, resulting in additional income tax, interest, and penalty.

Taxpayers timely protest the assessments. A hearing was held. Prior to the administrative hearing, based on additional documentation submitted by Taxpayers, the Department corrected some mathematical errors contained in the audit summary and applied EDGE credits.

Taxpayers, however, continue to protest the remaining issues, namely, the proposed combination of filing, the disallowance of NOLs, and the penalties. This Letter of Findings ensues and addresses the remaining issues. Additional facts will be provided as necessary.

DISCUSSION

I. Corporate Income Tax – Imposition.

The Department's audit found that Taxpayers, through various intercompany activities, maintained a unitary relationship. Upon reviewing Taxpayers' returns, as filed, the Department's audit concluded that the returns, through deductions on various expenses between the intercompany activities, had underreported their taxable income in Indiana, resulting in shifting the deemed Indiana income out of Indiana for those years. Thus, to fairly reflect Taxpayers' taxable income derived from sources within Indiana, the Department's audit combined their filings for those years, which eliminated the intercompany transactions among Taxpayers.

Taxpayers, to the contrary, maintain that those intercompany transactions have business purpose/economic substance and were conducted at "arm's length." Taxpayers thus argued that their Indiana returns, as filed, did not create distortion. In the alternative, Taxpayers argue that, assuming that the Department could combine Taxpayers' filings for those years, the Department does not have the statutory authority to include some of the qualified foreign operating companies, such as O3, and an insurance company O4 into the proposed combined returns.

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 Dept of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

A. Combined Return.

To fairly reflect their income derived from sources within Indiana, the Department's audit combined Taxpayers' filings for those years, which eliminated the intercompany transactions. Taxpayers, to the contrary, claim that their intercompany transactions were conducted at "arm's length" and the returns should remain as filed because they did not distort Taxpayers' Indiana income.

"Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. [IC § 6-3-2-1(b).] In cases where a corporation derives business income from sources both within and without Indiana, the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996).

The United States Supreme Court's jurisprudence has established what is classified as a "unitary business" and allows a State to apply formula apportionment taxing some income (which a taxpayer's subsidiaries/affiliates received), which does not have its source in the taxing State. When in dispute, the Court examines whether "contributions to income of the subsidiaries resulted from functional integration, centralization of management, and economies of scale." Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 179 (1983). A business is considered unitary, when "there is (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use of its centralized executive force and general system of operation." Butler Brothers v. McColgan, 111 P.2d 334, 341 (CA.1941), aff'd, 315 U.S. 501 (1942). See also Barclays Bank PLC v. Franchise Tax Bd. of California, 512 U.S. 298, 303-04, fn. 1 (1994).

IC § 6-3-2-2, in pertinent part, 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:
>
> (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.

...

(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).

45 IAC 3.1-1-62 further explains:

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1---37--45 IAC 3.1-1-61] (45 IAC 3.1-1) 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.

In this instance, the Department's audit determined that Taxpayers, having unity of ownership, unity of use, and unity of operation, are in a unitary business–manufacturing and selling various products. The Department's audit also found that various intercompany transactions among and within Group A, B, and O created distortions, which rendered Taxpayers' returns, as filed, understating their income derived from sources within Indiana.

1. Licensing and Royalty Payments.

The Department's audit first found that during 2002 and 2003, A1 paid royalties to A2 (a Delaware corporation headquartered outside of Indiana) for using the intangible property, such as trademarks and trade names, which A1 originally owned and later transferred to A2. The Department's audit further noted that A1 incurred the advertising cost and the royalty payments as business expenses, to use the very same trademarks/trade names A1 originally owned, and that A1's royalty payments consisted of ninety-eight (98) percent of A2's royalty income for those years. The Department's audit also observed that while Taxpayers filed combined return in A2's headquarters state, those intercompany transactions were eliminated and the royalty income was not subject to state income tax in that state. A2's royalty income was also not subject to state income tax in Delaware, where there is no income tax on intangibles. The Department's audit further noted that, by the end of 2003, A1 stopped paying A2 royalties.

2. Three-Party (Manufacturing-Licensing/Holder of IP/Owner of Finished Goods–Sales and Distribution) Business Operation.

a. Group A.

The Department's audit noted that, beginning in 2004, A1, A2, and A3 embarked on a three-party structure of business operation, similar to arrangements among and within Group B. The Department's audit, in relevant part, provided that:

[A2] is the owner of all [A1's] intellectual property and employs all of the management personnel at its headquarters.... The west coast manufacturing plants and [] distribution centers owned by [A2] are now leased to [A1].

[A1] is the contract manufacturer for [A2]. [A1] owns all the manufacturing and [most warehousing facilities] and employs all the manufacturing and warehousing personnel. [A1] also contracts with third parties to produce finished goods.

[A3] is the sales and distribution entity for [A2]. [A3] owns the trucks and most of Taxpayer's distribution centers... and employs the sales force. [A3] also contracts with third parties for bins and regional sales office space.

[A1] purchases raw materials from independent suppliers to produce the finished goods. The finished goods are sold to [A2]. [A2] in turn sells the finished goods to [A3] for sale [sic] and distribution.

The Department's audit observed that, in 2004, upon deducting the alleged expenses, A1 and A3 together claimed a combined loss in excess of $200 million in Indiana for 2004. A2, which reported income on several billion dollars of sales, did not file the Indiana return, even though A2 acquired the finished goods from A1, and then held, transferred, and eventually sold the finished goods to A3 for distribution. The Department's audit further noted that, pursuant to a combination of filing, Taxpayer actually made a profit in excess of $500 million after the intercompany transactions were eliminated.

b. Group B.

According to the Department's audit, Taxpayer, through its wholly-owned first tier subsidiary, a Capital Corporation, wholly owns B1. Similar to the Group A's three-party structure of business operation, B2 was the contract manufacturer for B1 and B3 was the contract manufacturer for B4. The Department's audit noted that both B1 and B4, upon acquiring the title of finished goods, then transferred and sold the finished goods to B5, which managed sales and distribution for Group B's finished products during these years. Upon reviewing their Indiana consolidated returns, the Department's audit noted that while B2 and B3, consistently operating on losses

for those years, filed Indiana returns, but, B1 and B4, which had large profits each year did not file the Indiana returns. The Department's audit further observed that B1 wholly owns B2 and B5 as well as maintains ninety-nine (99) percent of B4, which, in turn, wholly owned B3. While the affiliates deducted the alleged expenses, the money also directly or indirectly returned to B1, the Group-Parent, and ultimately, Taxpayer, in the form of dividends.

3. Management Administrative Service Fees.

The Department's audit noted that a partnership, A5, which Taxpayer and O1 are the two partners, was established to provide management administrative services for affiliates, namely A1 and A4. The Department's audit found that, upon establishing A5, A1's headquarters were transferred to A5 and A5 then charged A1 and A4 for the use of headquarters and administrative management services. While A1 and A4 deducted the management service fees (approximately $200 million) paid to A5, the money was distributed to the two partners, Taxpayer and O1. O1 then, in turn, loaned the money to A1.

4. Loans and Interest Payments.

The Department's audit noted that the majority of O1, O3, and O4's source of income was interest income through and from intercompany loans to the subsidiaries/affiliates and Taxpayer, the ultimate Parent. The Department's audit also found that O1, wholly-owned by Taxpayer, received income distribution from A5, the partnership.

Thus, the Department's audit concluded that:

> The various intercompany transactions are mutually beneficial, dependant [sic] upon and contribute to one another.... [D]ue to the complexity and substantial number of inter-company activities, and the various distortions as shown above, combining all the [Taxpayers] is the only way to fairly reflect income/loss to be apportioned to Indiana. Taxpayer was presented with a letter [dated March 31, 2009] asking for any alternative approaches to be the above but none were offered.

Taxpayers, in the August 18, 2009 letter, protested the Department's proposed assessments which were calculated based on the proposed combined filings. In the June 10, 2010 protest brief, Taxpayers first argued that "although the corporations were engaged in a unitary relationship, because they conducted their business at arm's length and there were legitimate business reasons for their actions, combined filings could not be required." Taxpayer maintained that the intercompany transactions, having business purpose and economic substance, were based on reasonable agreements with "arm's-length" prices which were established by several independent transfer pricing studies pursuant to I.R.C. § 482.

Taxpayers further argued that the Department's audit erroneously compared other states' laws, and used those combined filings as benchmarks to determine whether there was distortion. Additionally, Taxpayers asserted that since the intercompany transactions were based on "arm's-length" prices which were supported by several independent transfer pricing studies, there was no distortion.

To support its protest, Taxpayers provided documentation including, but not limited to, the federal consolidated returns and Form 851s, Partnership's informational returns, Indiana and non-Indiana state tax returns, licensing agreements, and intercompany promissory notes. However, referring to the corporate policy, Taxpayers declined to submit copies of the transfer pricing studies to substantiate their claim. Upon reviewing Taxpayers' documentation, the Department is not able to agree that Taxpayers have met their burden demonstrating that the intercompany transactions were "arm's length."

The Department, in its Letter of Findings 02-20090918 (March 12, 2010), in relevant part, clearly explains:

> 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.... 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.

Even if, for the purpose of argument, the above mentioned intercompany transactions were supported by the alleged transfer pricing studies, the business operations, which Taxpayers embraced, fail to reflect economic reality. As the Department's audit stated:

> Transfer pricing studies were determined not to be relevant to this situation, as it was not the arm's length nature of the transactions but the totality of the intercompany mark-ups that created the understating of taxable income. All of the various intercompany transactions such as the management fee for the corporate headquarters, royalty fees, and the circle of products for the manufacturing company, to marketing company, to sales company, to the customer, all cause the final income to contain a multiple level of intercompany charges which overstate actual expenses and underreport taxable income.

Upon reviewing Taxpayers' documentation, those transactions were specifically performed among and within the controlled affiliate groups. Taxpayers could assert those transactions were supported by transfer pricing studies as "arm's length." Even if, for the sake of argument, the Department agrees that Taxpayer's transfer pricing studies set bona fide "arm's length" rates for the intercompany transactions, the analysis, under Indiana law, does not stop there. In this instance, Taxpayers' complex, multi-tiered structure and the concomitant flow of multi-layered intercompany payments and expense deductions result in a significant deflation of the income actually earned in Indiana. Furthermore, Taxpayers' documentation showed that the money flowed through various affiliate companies in different formats but, ultimately, the money returned to the controlled affiliate groups which initially incurred the expenses. If Indiana determines, as it did here, that Taxpayers income tax returns report income that does not fairly reflect Taxpayer's business activity in the state, then, pursuant to IC§ 6-3-2-2 (l) and (m), 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."

Finally, Taxpayers asserted that the Department's audit failed to demonstrate that "combined filing is the only way to correct distortion." Thus, Taxpayers argued that pursuant to IC § 6-3-2-2(q), the Department cannot force Taxpayer and its subsidiaries/affiliates to file the combined returns.

Taxpayers are mistaken. IC § 6-3-2-2(l) and (m) permit the Department to employ "any other method to effectuate an equitable allocation and apportionment of" Taxpayers' income in order to fairly reflect and report the income derived from sources within the state of Indiana. Meanwhile, IC § 6-3-2-2(q) imposes a limitation which the Department "may not 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, 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)."

The Department's audit considered potential alternatives to fairly reflect Taxpayers' income derived from sources within Indiana pursuant to IC § 6-3-2-2(l) and (m), but, concluded, in relevant part:

> Separate accounting would not be fair to taxpayer as operations like [Group T] would not be included in the return. [Group T] is part of taxpayer's unitary beverage business. [Group T] sustained losses each year and provided taxpayer with factor relief by including them in the combined return.
>
> ...
>
> By including all companies in a combined return the result in a matching of actual income and expenses that fairly reflects the income actually earned. More importantly this allows taxpayer factor relief for all companies included in the return.

Taxpayers did not offer any tenable alternatives upon receiving the Department's March 31, 2009 letter. Nor did Taxpayers, at the hearing and/or subsequently after, offer any documentation or present any alternative calculations to show that combined returns will be less favorable and unfair. Taxpayers were afforded opportunities to propose and justify filing methods, which may have overcome the Department's conclusion but Taxpayers chose not to do so.

Given the totality of the circumstances, in the absence of other documentation, the Department is not able to agree that Taxpayers have met their burden.

B. Inclusion of Foreign Operating Corporations.

Taxpayers asserted that the Department's audit, by using information from Taxpayers' federal consolidated returns, erroneously included various qualified foreign operating affiliate companies, such as O3.

IC 6-3-2-2(o) states:

> 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.

To support their protest, Taxpayers submitted separate federal returns and calculations, but also conceded that one entity was determined to be ineligible. Thus, upon reviewing Taxpayers' documentation, it is likely that the Department's audit mistakenly includes some foreign operating affiliate companies into the combined returns.

Pending supplemental audit verification, the Department will remove those qualified foreign operating companies accordingly. Taxpayers, therefore, are instructed to promptly provide additional documentation, if needed, upon request of the Department's Audit Division to support the supplement audit.

C. Inclusion of Captive Insurance Company.

Taxpayers asserted that the Department's audit erroneously includes Insurance Company O4. Taxpayers maintained that, pursuant to IC § 6-3-2-2(r), the Department cannot include O4's income into the combined returns.

IC § 6-3-2-2(r) states:

> This subsection applies to a corporation that is a life insurance company (as defined in Section 816(a) of the

Internal Revenue Code) or **an insurance company that is subject to tax under Section 831 of the Internal Revenue Code**. The corporation's adjusted gross income that is derived from sources within Indiana is determined by multiplying the corporation's adjusted gross income by a fraction:

(1) the numerator of which is the direct premiums and annuity considerations received during the taxable year for insurance upon property or risks in the state; and

(2) the denominator of which is the direct premiums and annuity considerations received during the taxable year for insurance upon property or risks everywhere.

The term "direct premiums and annuity considerations" means the gross premiums received from direct business as reported in the corporation's annual statement filed with the department of insurance. (**Emphasis added**).

I.R.C. § 831 provides:

(a) General rule.–Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company.

(b) Alternative tax for certain small companies.

(1) In general.–In lieu of the tax otherwise applicable under subsection (a), there is hereby imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company for such taxable year by the rates provided in section 11(b).

(2) Companies to which this subsection applies.

(A) In general.–This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if–

(i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $1,200,000, and

(ii) such company elects the application of this subsection for such taxable year.

The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (i) are met. Such an election, once made, may be revoked only with the consent of the Secretary.

(B) Controlled group rules.

(i) In general. –For purposes of subparagraph (A), in determining whether any company is described in clause (i) of subparagraph (A), such company shall be treated as receiving during the taxable year amounts described in such clause (i) which are received during such year by all other companies which are members of the same controlled group as the insurance company for which the determination is being made.

(ii) Controlled group. –For purposes of clause (i), the term "controlled group" means any controlled group of corporations (as defined in section 1563(a)); except that–

(I) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a), and

(II) subsections (a)(4) and (b)(2)(D) of section 1563 shall not apply.

(3) Limitation on use of net operating losses.--For purposes of this part, except as provided in section 844, a net operating loss (as defined in section 172) shall not be carried–

(A) to or from any taxable year for which the insurance company is not subject to the tax imposed by subsection (a), or

(B) to any taxable year if, between the taxable year from which such loss is being carried and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by subsection (a).

(c) Insurance company defined.--For purposes of this section, the term "insurance company" has the meaning given to such term by section 816(a).

(d) Cross references. –

(1) For alternative tax in case of capital gains, see section 1201(a).

(2) For taxation of foreign corporations carrying on an insurance business within the United States, see section 842.

(3) For exemption from tax for certain insurance companies other than life, see section 501(c)(15).

Treas. Reg. § 1.801-1(b)(2) further explains:

Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, **the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code**. For example, during the year 1954 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the year 1954

within the meaning of the Code and the regulations thereunder. (**Emphasis added**).

To support its protest, Taxpayer submitted copies of O4's [State] Certificate of Incorporation, [State] Certificate of Authority, [State] Certificate of General Good, 2004 Insurance Policy, federal 1120-PC forms and [State] Insurance Premium Tax Returns for those years.

Upon reviewing Taxpayers' documentation, notably, O4 has been a captive insurance company, properly licensed under law of [State], to provide insurance coverage concerning "Workers' Compensation and Employers' Liability." O4, however, only provided insurance coverage to Taxpayer (Parent) and its subsidiaries. The premium paid by Taxpayer was O4's sole premium income. While O4 reported its premium income to the [State], O4 also had investment income, which O4 reported on its 1120-PC forms for those years. Taxpayers' documentation showed that O4's investment income was proximately four (4) times of the insurance premium income during those years. Although O4 was properly registered and licensed to conduct insurance business under [State] law, O4 was not qualified as an insurance company pursuant to the above mentioned statute and regulation because its primary source of income was investment income.

In short, Taxpayer's documentation demonstrated that O4, though properly registered and licensed to conduct insurance business, was not qualified as an insurance company that is subject to tax under I.R.C. § 831 for those years. Thus, IC § 6-3-2-2(r) is not applicable.

FINDING

Taxpayers' protest of Subpart B is sustained subject to the Department's verification. The Department will remove qualified foreign operating companies upon verification in the supplemental review. Taxpayers' protest of Subpart A and C, however, is respectfully denied.

II. Corporate Income Tax– Net Operating Losses ("NOLs").

DISCUSSION

Taxpayers protest that the Department's audit disallowed their NOLs: (1) Parent's losses in excess of $70 million from its previous audit ("Parent's NOLs"), (2) Group A's NOLs from 1997 through 2000, and (3) Group A's 2001 NOLs.

IC § 6-3-2-2.6 (2002) [The statutory change in 2004 is not relevant to Taxpayer's protest.] states:

(a) This section applies to a corporation or a nonresident person for a particular taxable year, if the taxpayer's adjusted gross income for that taxable year is reduced because of a deduction allowed under Section 172 of the Internal Revenue Code for a net operating loss. For purposes of section 1 of this chapter, the taxpayer's adjusted gross income, for the particular taxable year, derived from sources within Indiana is the remainder determined under STEP FOUR of the following formula:

STEP ONE: Determine, in the manner prescribed in section 2 of this chapter, the taxpayer's adjusted gross income, for the taxable year, derived from sources within Indiana, as calculated without the deduction for net operating losses provided by Section 172 of the Internal Revenue Code.

STEP TWO: Determine, in the manner prescribed in subsection (b), the amount of the taxpayer's net operating losses that are deductible for the taxable year under Section 172 of the Internal Revenue Code, as adjusted to reflect the modifications required by IC 6-3-1-3.5, and that are derived from sources within Indiana.

STEP THREE: Enter the larger of zero (0) or the amount determined under STEP TWO.

STEP FOUR: Subtract the amount entered under STEP THREE from the amount determined under STEP ONE.

(b) For purposes of STEP TWO of subsection (a), the modifications that are to be applied are those modifications required under IC 6-3-1-3.5 for the same taxable year during which each net operating loss was incurred. In addition, for purposes of STEP TWO of subsection (a), the amount of a taxpayer's net operating losses that are derived from sources within Indiana shall be determined in the same manner that the amount of the taxpayer's income derived from sources within Indiana is determined, under section 2 of this chapter, for the same taxable year during which each loss was incurred. Also, for purposes of STEP TWO of subsection (a), the following procedures apply:

(1) The taxpayer's net operating loss for a particular taxable year shall be treated as a positive number.

(2) A modification that is to be added to federal adjusted gross income or federal taxable income under IC 6-3-1-3.5 shall be treated as a negative number.

(3) A modification that is to be subtracted from federal adjusted gross income or federal taxable income under IC 6-3-1-3.5 shall be treated as a positive number.

A. Parent's NOLs.

The Department's audit agreed that Parent has NOLs primarily based on the conclusion of a 2007 audit (2007 Audit). The Department's audit, however, proposed that the Department would have recalculated based on the proposed combined filings and applied to earlier years and Taxpayers would have no NOLs available to carry forward to 2002, 2003, and 2004 in this audit. Taxpayers, to the contrary, maintained that the NOLs should be available.

Indiana follows the federal rules concerning the application of NOLs. In Phoenix Coal Co. v. C.I.R., 231 F.2d 420 (C.A.2 1956), the taxpayer reported income and paid a tax thereon in 1945 and 1946, but, in 1947 and 1948,

the taxpayer reported a net operating loss. Id. at 421. The taxpayer in Phoenix Coal "carried back to 1945 a portion of the 1947 net loss sufficient to wipe out net income in 1945, and then carried back the remainder of the 1947 loss to 1946." Id. The taxpayer's "1948 net loss was then carried back in toto to reduce further the 1946 net income." Id. The taxpayer, in Phoenix Coal, then "filed an application for a tentative carry-back adjustment based upon net operating loss carry-backs from 1947 to 1945 and 1946." Id. The Commissioner of Internal Revenue ("Commissioner") made refund of entire income tax paid for 1945 and additional refund for 1946. However, the Commissioner later recomputed 1945 income and disallowed certain deductions, resulting in less NOLs available to be carried back and applied in 1946. As a result, the taxpayer was assessed a deficiency for 1946. The court found that the Commissioner, in making adjustments of 1946 income tax and in determining a deficiency for 1946, properly considered items on 1945 return, though adjustment of 1945 return was barred by the three-year limitation period. Id. The court concluded that "[t]his assessment of deficiency came less than three years after the filing of the 1946 return, but more than three years after the filing of the 1945 return." Id.

In this instance, unlike the taxpayer in Phoenix Coal, Taxpayers stated that the Department concluded that Taxpayers, based on its 2007 Audit, had Parent's NOLs available to be carried forward. Taxpayers further maintained that the Department, in the current audit, also has confirmed the 2007 Audit's NOLs finding, with a small increase, which Taxpayers have Parent's NOLs available to be carried forward. Additionally, Taxpayers asserted that, since 1985, the Department has audited and closely reviewed Taxpayers' filings almost every year and did not change Taxpayers' filings, namely, combined returns. Taxpayers thus argued that since the Department had the opportunities to closely review and agreed to Parent's then NOLs, based on 2007 Audit, the NOLs should remain available.

Taxpayer's documentation showed that the Department's audit has reviewed Taxpayers' filings and agreed that Taxpayers have Parent's NOLs available to be carried forward. Thus, Taxpayers' protest is sustained.

B. Group A's NOLs.

The Department disallowed Group A's 1998 and 2000 NOLs as well as 2001 NOLs. Taxpayers, to the contrary, claimed those NOLs are available to be carried forward.

1. 1998 and 2000 NOLs.

The Department's audit found that, in 2003, a separate audit concerning Group A's 1997 through 2000 tax years was concluded ("2003 Audit"). Pursuant to the 2003 Audit, the Department had proposed assessments based on combining Group A's filings for those years and had concluded that Group A had profits during those years. Thus, the Department determined that Taxpayers did not have any Group A NOLs from 1998 and 2000 to be carried forward to the current audit. Taxpayers claimed that, in 2005, upon receiving the Department's proposed assessment based on the 2003 Audit, it protested the proposed assessment and the Department cancelled the liabilities. Thus, Taxpayers asserted that the Department had revised its 2003 Audit and, therefore, Group A's NOLs should remain available to be carried forward.

To support its protest, Taxpayers produced a copy of the letter, dated November 22, 2005, stating, in relevant part, that "[t]his letter confirms that the Department has cancelled the corporate income tax liabilities of" Group A.

Taxpayers are mistaken. The Department may cancel a taxpayer's liability for many different reasons. For instance, the Department could reach a comprise solution with a taxpayer and, therefore, cancel the taxpayer's tax liabilities based upon the agreement. The November 22, 2005, letter did not offer any explanation. Nor did the Department state that it had revised its conclusion of the 2003 Audit. Thus, the Department is not able to agree that Taxpayers have met its burden demonstrating that the Department had revised its 2003 Audit.

In short, based on the 2003 Audit, Group A did not have any NOLs available to be carried forward.

2. 2001 NOLs.

The Department determined that Group A has NOLs from 2001 and which are available subject to the federal general rule. The Department's audit, however, stated that Group A's 2001 NOLs must be carried back first before the NOLs can be carried forward because Group A did not forgo the carryback election. Taxpayers, to the contrary, argued that the Department's audit could not rely on the Group A's election because the Department proposed to combine Group A with Taxpayers' filings. Thus, the Department should make the determination based on Parent's election.

The Department agreed that Taxpayers' argument is reasonable and requested a copy of Taxpayers' 2001 federal return to put this disagreement at rest. As a result, Taxpayers responded that Parent's 2001 federal return also did not forgo the carryback election. Thus, the issue of the Group A's 2001 NOLs is moot.

In short, Taxpayers' protest of the Parent's NOLs is sustained subject to the appropriate federal rules. Taxpayers' protest of the Group A's 1998 and 2000 NOLs as well as 2001 NOLs is respectfully denied.

FINDING

Taxpayers' protest of the Parent's NOLs is sustained subject to the appropriate federal rules. Taxpayers' protest of the Group A's 1998 and 2000 NOLs as well as 2001 NOLs is respectfully denied.

III. Tax Administration – Underpayment Penalty and Negligence Penalty.

DISCUSSION

Taxpayers protest the imposition of the underpayment penalty and negligence penalty.

A. Underpayment Penalty.

The Department imposed an underpayment penalty because Taxpayers failed to timely remit their estimated payments of adjusted gross income tax under IC § 6-3-4-4.1(d).

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:

(1) the annualized income installment calculated under subsection (c); or

(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.

Taxpayers have provided sufficient documentation demonstrating that the imposition of the underpayment is not appropriate.

B. Negligence Penalty.

Taxpayers also protest the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a return for any of the listed taxes;

(2) 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;

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

(4) fails to timely remit any tax held in trust for the state; or

(5) is required to make a payment by electronic funds transfer (as defined in IC 4-8.1-2-7), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

45 IAC 15-11-2(b) further 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), in part, 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. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayers did not provide sufficient documentation to demonstrate that their failure to pay tax was not due to negligence.

FINDING

Taxpayers' protest of the underpayment penalty is sustained, but Taxpayers' protest of negligence penalty is respectfully denied.

SUMMARY

For the reasons discussed above, on the Issue I, Taxpayers' protest of Subpart B is sustained subject to the Department's verification. The Department will remove qualified foreign operating companies upon verification of the supplemental review. Taxpayers' protest of Subpart A and C, however, is respectfully denied.

On the Issue II, Taxpayers' protest of the Parent's NOLs is sustained subject to the appropriate federal rules. Taxpayers' protest of the Group A's 1998 and 2000 NOLs as well as 2001 NOLs is respectfully denied.

On Issue III, Taxpayers' protest of the underpayment penalty is sustained, but Taxpayers' protest of

negligence penalty is respectfully denied.

Posted: 03/23/2011 by Legislative Services Agency
An html version of this document.